Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-115-00
[redacted]

date: FEB 17 2000

to: Examination Division, [redacted]
ATTN: [redacted]

from: Associate District Counsel, [redacted]

subject: **ADVISORY OPINION -**
Taxpayer: [redacted]
TIN:
Taxable Years:

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This memorandum responds to your January 5, 2000, request for advice concerning the appropriate tax treatment of expenditures made to settle arbitration and litigation claims, and amounts received in settlement of another claim. This advice is based on the facts as provided in your January 5, 2000 memorandum, which we have attempted to summarize below. If any of the facts are not as stated, you should provide us with the additional facts so that we can determine whether our advice requires revision.

ISSUES

I. Whether $[redacted] paid by the taxpayer to the [redacted] in [redacted] in settlement of arbitration claims and related litigations is currently deductible.[1]

II. Whether $[redacted] received by the taxpayer in settlement of its claim against [redacted] in [redacted] is includible in income.

CONCLUSION

I. The treatment of the $[redacted] paid by the taxpayer in [redacted] in settlement of arbitration claims, and related litigation claims, appears to be primarily an expense that should be capitalized to the extent that the origins of the claims are related to the taxpayer's acquisition of a new business. As one of the claims being settled related to a breach of an employment contract, it is possible that, to the extent that a portion of the settlement can be determined to relate to that claim, the taxpayer might be entitled to a current deduction for a portion of the settlement. Legal fees incurred by the taxpayer should be allocated along the lines of the related settlement income.

II. The $[redacted] settlement proceeds received by the taxpayer in [redacted] should be given consistent tax treatment (i.e., ordinary or capital) as the $[redacted] settlement expense paid by the taxpayer in [redacted].

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[1] The initial inquiry from the Examination Division is set forth in issue two. We have also addressed your other inquiry, which you appear to have added after preparation of the request for the initial inquiry, which is: "Also, the question comes up if we should take an inconsistent alternative position [that] the $[redacted] deduction in [redacted] should be disallowed in the revenue agent's report." We have addressed the additional inquiry as issue one.

FACTS

[redacted] is a Delaware corporation wholly-owned by a German corporation, [redacted]. [redacted] has several wholly-owned subsidiaries, including [redacted] a Delaware corporation, and [redacted], a Delaware corporation.

[redacted] was formerly known as [redacted], which was formerly known as [redacted]); prior to its acquisition [redacted] was known as [redacted].

[redacted] and its subsidiaries filed consolidated federal income tax returns for the taxable years ending [redacted], [redacted] and [redacted]. The Service is currently auditing [redacted] and subsidiaries for taxable years [redacted], [redacted] and [redacted].

[redacted] provides engineering services involving [redacted], subcontracting most of the fabrication and construction work. One such subcontractor was [redacted]. [redacted] was owned by the [redacted] family, [redacted], [redacted], and [redacted], [redacted].

In [redacted], [redacted] acquired [redacted]. The parties entered into a stock purchase agreement, which contained, in part, the following terms:

1. $[redacted] cash payment to [redacted] & [redacted]
2. $[redacted] cash payment to [redacted]
3. $[redacted] promissory note to [redacted] & [redacted]
4. A [redacted]-year earnout provision based on a percentage of the pre-tax profit of [redacted] for [redacted] & [redacted]
5. An employment agreement with [redacted]
6. Two consulting agreements with [redacted]
7. An equity guaranty provision for the benefit of [redacted]

Sometime after the acquisition, a dispute arose between [redacted] and the [redacted] regarding the acquisition. [redacted] believed that the [redacted] were required to repay over [redacted] dollars as part of the equity guaranty provision, had breached representations and warranties, and fraudulently misrepresented or concealed information.

In mid-[redacted], at a meeting of [redacted] and [redacted] allegedly to resolve the pending issues, [redacted] terminated [redacted] as [redacted]'s president, and, the same day, filed a Demand for Arbitration associated with the purchase of the [redacted] stock. The Demand for Arbitration alleged a breach of representations and warranties, fraud, and a repayment of guaranteed shareholders' equity. [redacted] believed the [redacted] had misrepresented the value of the [redacted] stock, and sought damages of $[redacted].

Two weeks later, [redacted] filed a Demand for Arbitration alleging breach of the employment agreement, and sought damages of $[redacted].

The [redacted] believed that [redacted] had delayed the completion of a final audit report in order to allow [redacted] time to manipulate [redacted]'s financial condition, and that [redacted] had failed to properly fund and manage [redacted] to allow it to operate more successfully.

In [redacted], [redacted] and [redacted] filed a Response to [redacted]'s Demand for Arbitration denying [redacted]'s allegations, alleging that [redacted]'s contractual claims were barred by its own fraud, breaches and bad faith, and alleging that [redacted] had failed to sufficiently allege fraud and misrepresentation.[2] [redacted] and [redacted] filed a counterclaim, seeking $[redacted], comprised of the following:

1. $ [redacted] amount remaining due under the $[redacted] promissory note
2. $ [redacted] amount paid by [redacted] pursuant to an inventory agreement that has been converted by [redacted]
3. $[redacted] amount remaining due the [redacted] under the [redacted]-year earnout provision
4. $ [redacted] estimated attorneys' fees and costs

   $[redacted]

The [redacted] alleged that, prior to their sale of [redacted], an independent consultant had valued [redacted] for purposes of the sale at between $[redacted] to $[redacted]. Since [redacted] was willing to pay $[redacted], the parties negotiated the following sales terms: 1) $[redacted] down payment; 2) an additional $[redacted] to be paid over [redacted] years[3]; and 3) an earnout of between [redacted]% to [redacted]% of the pre-tax profit of [redacted] for the next [redacted] years (which the [redacted] believed could be as much as $[redacted], bringing the purchase price within the range estimated by the [redacted] advisers). The

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[2] Additional actions taken by the [redacted] were: 1) on [redacted], they filed a suit in state court for an injunction against [redacted] and; and 2) on [redacted], they filed a suit in the United States District Court.

[3] It is not clear how this $[redacted] payment over [redacted] years corresponds with the $[redacted] promissory note to [redacted] and [redacted], previously discussed.

[redacted] alleged that [redacted] structured the purchase in such a manner to avoid paying more than $[redacted]. The [redacted] further alleged that [redacted] made misrepresentations, failed to make certain disclosures, breached its obligation to deal in good faith, and defaulted on the stock purchase agreement, promissory note and an inventory agreement.[4] The [redacted] also alleged that [redacted] and [redacted] made defamatory statements.

In [redacted], [redacted] filed a Statement of Claims and Defenses. He denied [redacted]'s allegations that he had fraudulently: (1) failed to disclose: (a) potential tax liabilities, and (b) problems on certain projects; and (2) overstated: (a) [redacted]'s backlog of contracts, and (b) [redacted]'s contract values. [redacted] alleged that any of [redacted]'s causes of action not based on fraud were barred under the terms of a non-suit clause in the stock purchase agreement, for which [redacted] reduced his sales price by $[redacted].

[redacted] alleged that [redacted] had, prior to purchasing [redacted], conducted a six-month comprehensive and in-depth review of [redacted]'s books, records, contracts and personnel. As part of the acquisition process, the [redacted] were required to provide audited financial statements for [redacted] to review. For the audit, the [redacted] engaged the services of [redacted]").[5] Under the terms of the stock purchase agreement, [redacted] was not obligated to purchase [redacted] until it was satisfied with the results of its review.

[redacted] sought $[redacted] (the amount by which he reduced his sales price to obtain the non-suit clause in the absence of fraud), plus attorneys' fees and costs. He also alleged that [redacted] had made defamatory statements about him.

[redacted] retained the services of [redacted] as its witness in its arbitration case against the [redacted].

The subsequent actions of the parties involved resulted in a settlement just prior to the arbitration hearing. These actions were described in a letter from [redacted] attorney. Generally, [redacted] believed that because of the non-suit clause in [redacted]'s

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[4] It is not clear whether or how the inventory agreement relates to the stock purchase agreement.

[5] Although the [redacted] apparently engaged [redacted], it is unclear whether it was the [redacted] who selected [redacted]. According to [redacted]'s attorney, during the arbitration the [redacted] denied that they selected [redacted].

stock purchase agreement, and the terms of employment contract with [redacted], it would have to demonstrate fraud to maintain its claims against [redacted] and to terminate [redacted]'s employment agreement without economic penalty. The [redacted] in response, alleged that [redacted]'s conduct was tortious. [redacted] believed that [redacted]'s credible testimony was crucial to refute the [redacted] claims of [redacted]'s wrongdoing. The [redacted] had hired [redacted] to perform the audit required under the acquisition process. The [redacted] alleged that [redacted] failed to disclose to the [redacted] that they also worked for [redacted]'s German parent.[6] The [redacted] alleged that, based on that relationship, [redacted] had a conflict of interest and may have been inappropriately influenced by [redacted]'s German parent in a way that advantaged the [redacted] parent and disadvantaged the [redacted]. [redacted] believed that [redacted]'s credibility was critical as it would rely on [redacted]'s testimony to establish facts involving the [redacted] relationship, and the disclosure of the same to the [redacted].

According to the attorney for [redacted], a person by the name of [redacted] of [redacted], almost on the eve of the arbitration hearing (and after many earlier opportunities for disclosure had passed), disclosed certain internal [redacted] memoranda that "strongly intimated" that [redacted] the [redacted] partners in Europe, and a senior officer of [redacted]'s German parent were, while [redacted] was representing the [redacted] in the sale transaction, sending information about [redacted] to [redacted] to ingratiate itself with [redacted]. Because of the disclosure of this information, and particularly because of the very late hour at which it was disclosed after months of denials as to their conduct, [redacted] and [redacted]'s senior executives' credibility was seriously impaired. [redacted] believed that the case would look as the [redacted] had contended: [redacted] and the [redacted] executives had lied throughout the arbitration on that issue. [redacted]'s counsel felt that the issue of [redacted]'s credibility was critical not only to [redacted]'s position on the disclosure issue, but also on all of the issues in the case; and that the perceived "provable lack of candor by [redacted]," which would have been established on the first issue to be tried, seriously impaired [redacted]'s credibility and its ability to prove its position on that and all later issues. The potential "domino

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[6] [redacted]'s attorney states that prior to any engagement of [redacted] by the [redacted] in connection with the acquisition, both [redacted] and [redacted] disclosed to the [redacted] that [redacted] also worked, on a worldwide basis, for [redacted]'s German parent, and that during the arbitration the [redacted] were especially vigorous in denying any such disclosure.

effect" on the other issues was viewed to be staggering, increasing significantly the chance that the [redacted] could establish the veracity of their claims, thus making it prudent for [redacted] to pay to discharge the claims rather than to risk trying them. As to [redacted] claims, [redacted] paid him because it could not effectively dispute his claims and because he had a good chance of proving that the arbitration was initiated because of [redacted]'s tortious conduct.

On [redacted], [redacted]'s attorney wrote a letter to [redacted]'s attorney pointing out that the existence of the secret communications between [redacted] and [redacted] was appalling, and the subsequent withholding of the documentary evidence of those communications was an outrage. [redacted]'s attorney stated that those and other facts indicated that [redacted]'s claims were concocted, and were being pursued in bad faith.

Three days later, on [redacted], [redacted] agreed to the settlement with the [redacted]. The settlement called for [redacted] to pay $[redacted] to [redacted] and [redacted], as follows:

1. $ [redacted] Reimbursement to [redacted] and [redacted] for costs incurred in the litigation and arbitration matters being settled;
2. $[redacted] Compensation for personal injury to the [redacted] personal reputations, personal embarrassment, mental and physical strain, and emotional damages as asserted in their defamation claims
3. $ [redacted] Repayment of monies given to [redacted] pursuant to the inventory agreement

[redacted] paid [redacted] $[redacted], which was not allocated in specific amounts, between the following two categories:

1. Reimbursement for costs incurred by [redacted] in connection with the litigation and arbitration matters;
2. Compensation for personal injury to [redacted]'s personal reputations, personal embarrassment, mental and physical strain, and emotional damages as asserted in his defamation claims.

Finally, as part of the settlement, the [redacted] assigned to [redacted] any rights they had, or thereafter acquired, to all claims they may have had against [redacted], together with a pledge of cooperation in the prosecution of any such claims.

On its [redacted] income tax return, [redacted] deducted $[redacted] for the settlement paid to the [redacted], computed as follows:

Amount paid to the [redacted]	$[redacted]	
Plus [redacted] Invoice	[redacted]	
Plus arbitration expenses	[redacted]	
		$[redacted]
LESS:		
Payment to [redacted] related to inventory agreement	$ [redacted]	
Accrued interest (deducted elsewhere)	[redacted]	
Balance of Promissory Note	[redacted]	
[redacted] adjustment		
Reduction of Purchase price		
		$[redacted]
		$[redacted]

On [redacted], [redacted] served notice of his intention to commence a civil action against [redacted] of [redacted], based on [redacted]'s alleged breach of its ethical and fiduciary duties to [redacted] who had retained [redacted] to audit [redacted]. Specifically, [redacted] referred to [redacted] continuing to represent and engage in communications with the purchaser, [redacted].[7] [redacted] also noted that, after completion of the audit, [redacted] then agreed to represent [redacted] in efforts to challenge [redacted]'s own audit, and testified that the audit contained deceptive and fraudulent representations and omissions. All of which was allegedly done without consulting with or disclosing to [redacted] the nature of the firm's engagement with [redacted].

On [redacted], [redacted]'s attorney sent a letter to [redacted] explaining that [redacted] believed that [redacted]'s conduct substantially contributed to, if it was not entirely responsible for, [redacted]'s position swinging from an expectation of recovering $[redacted] to its having to pay $[redacted]. The letter also stated that [redacted], which had been retained as a witness in the arbitration proceeding, failed to disclose to [redacted] that [redacted]'s lawyers had provided a written opinion to [redacted] stating that [redacted]'s litigation support team did not believe that [redacted] could establish fraud, "which was essential to [[redacted]'s] success in the litigation and arbitration proceedings."

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[7] The facts do not explain the precise identity of [redacted]. For purposes of this opinion, we have assumed that it is the German parent, [redacted].

On [redacted], [redacted] and [redacted] agreed to settle their dispute by [redacted] paying $[redacted] to [redacted]. On its [redacted] income tax return, [redacted] did not report in income the $[redacted] settlement received from [redacted].

DISCUSSION

I. LAW

I.R.C. section 61(a) defines gross income as "all income from whatever source derived," subject to certain exclusions provided in the Code. Accordingly, any funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-31 (1955); Getty v. Commissioner, 913 F.2d 1486, 1490 (9th Cir. 1990), revg. 91 T.C. 160 (1988).

A deduction shall be allowed for all ordinary and necessary expenses paid during the taxable year in carrying on a taxpayer's trade or business. I.R.C. § 162; Treas. Regs. § 1.162-1. An expense is ordinary if it arises out of the normal operations of the business. Deputy v. du Pont, 308 U.S. 488 (1940). An expense is necessary if it is appropriate and helpful to the taxpayer's business. Welch v. Helvering, 290 U.S. 111, 114 (1933).

Code section 263 provides that no deduction is allowed for capital expenditures. Included in those expenses to be capitalized are those that are for the acquisition or disposition of capital assets. Woodward v. Commissioner, 397 U.S. 572, 575 (1970); United States v. Hilton, 397 U.S. 580 (1970). Treas. Reg. § 1.212-1(n) and 1.263(a)-2(a). Such expenditures are included in "the basis of the capital asset with respect to which they are incurred and are taken into account for tax purposes either through depreciation or by reducing the capital gain ... when the asset is sold." Woodward, 397 U.S. at 574-5; I.R.C. § 1001.

Legal expenses and settlement costs incurred in defending against a claim of fraud that would injure or destroy a business have been held to be ordinary and necessary business expenses. Commissioner v. Heininger, 320 U.S. 467 (1943) (legal expenses); North American Investment Co. v. Commissioner, 24 B.T.A. 419 (1931) (settlement payment). But legal expenses and settlement payments incurred to defend or protect title to property are nondeductible capital expenditures. Boagni v. Commissioner, 59 T.C. 708, 713 (1973)(legal expenses); Yates Industries, Inc. v. Commissioner, 58 T.C. 961 (1972), aff'd, 480 F. 2d 920 (3rd Cir. 1973)(settlement payment).

Whether a dispute is resolved through litigation or settlement, the nature of the underlying action determines the proper tax consequences. Tribune Publishing Co. v. United States, 836 F.2d 1176, 1177 (9th Cir. 1988). The taxability of a settlement is controlled by the nature of the litigation. Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (1st Cir. 1944), affg. 1 T.C. 952 (1943).

The nature of the litigation is, in turn, controlled by the origin and character of the claim which gave rise to the litigation. United States v. Gilmore, 372 U.S. 39 (1963). Both the consequences of the litigation and the taxpayer's motive or purposes in undertaking the litigation are immaterial. Id.

Gilmore involved the issue of whether a taxpayer could deduct a portion of his divorce legal expenses relating to protecting his interest in his business. The Supreme Court determined, using the origin of the claim test, that the expenses were non-deductible personal expenses rooted in the taxpayer's divorce, and were not deductible even though the taxpayer's purpose may have been to protect his business income.

In Gilmore, because the Court attributed the expenses to a purely personal transaction, the characterization of those expenses presented no problem. If the costs had been attributable to a business transaction, it would have been necessary to determine if the costs represented deductible expenses or adjustments to the cost of a capital asset. See Keller Street Development Company, et al. v. Commissioner, 688 F.2d 675 (9th Cir. 1982), aff'g T.C. Memo. 1978-350.

Courts have rejected arguments by taxpayers that the origin of the claim analysis in Gilmore is limited to determining whether income and expenses are business or personal; the same test is used to determine in a business context whether settlement proceeds constitute ordinary income or capital income, and whether a settlement payment constitutes an ordinary and necessary expense, or a capital expenditure. See Anchor Coupling Co., Inc. v. United States, 427 F.2d 429 at 432-33 (7th Cir. 1970) ("Although the two questions are admittedly different, substantially the same problems arise in each determination.")

A significant expansion of Gilmore occurred in Woodward, 397 U.S. 572 (1970), and its companion case, Hilton Hotels, 397 U.S. 580 (1970). In those cases, the Court extended the origin of the claim test to the determination of whether an ordinary and necessary business expense was a currently deductible expenditure or a capital expenditure.

Woodward involved the attribution of various expenses incurred by shareholders in an appraisal action. The taxpayers were majority holders of an Iowa corporation, where state law allowed shareholders to vote on a perpetual extension of corporate charter. If the approval is not unanimous, the dissenting minority holders must be allowed to sell their shares for "real value." In Woodward, the dissenting minority and the majority could not agree on "real value." The majority holders brought an appraisal action. Following resolution of the "real value" issue, the majority holders sought to deduct the cost of the appraisal as an "ordinary and necessary" business expense. The Eighth Circuit disagreed, and disallowed the deduction, Woodward v. Commissioner, 410 F.2d 313 (8th Cir. 1969). The Supreme Court affirmed.

The basis of the taxpayers' argument was that their "primary purpose" in expending the funds was to allow their business to continue. They noted that the appraisal action did not involve any title issues, only the value of the shares. The Supreme Court rejected the "primary purpose" test. "A test based on the taxpayer's 'purpose' in undertaking or defending ... litigation would encourage resort to formalisms and artificial distinctions." Woodward, 397 U.S. at 577. Instead, the Court applied the "origin of the claim" test as established in Gilmore. Woodward, 397 U.S. at 578. The establishment of a price being a crucial part of a purchase of assets, the Court determined that the appraisal action originated in the efforts to buy the stock; thus, the appraisal costs were attributed to the stock purchase. As the purchase of stock was a capital transaction for tax purposes, the cost of the appraisal was characterized as a part of the cost of the stock acquired. It was treated as an adjustment to basis, not a deductible expense. Id. at 578-79.

The companion case, Hilton Hotels, involved the cost of an appraisal arising from dissenters' rights in a merger. The taxpayer tried to distinguish Woodward on the ground that title to the stock passed prior to a value being fixed. The court saw no distinction, and applied the same reasoning as in Woodward. Hilton Hotels, 397 U.S. at 583-85.

Following Woodward and Hilton Hotels, the Court of Appeals for the Ninth Circuit has explicitly applied the origin test on several occasions.[8] In Redwood Empire Savings & Loan Association v.

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[8] Numerous opinions in circuits other than the Ninth Circuit apply the origin rule under many varied circumstances: McDonald v. Commissioner, 592 F.2d 635 (2nd Cir. 1978)(expense in will contest based on personal right under will, no deduction); Newark Morning Ledger Co. v. United States, 539 F.2d 929 (3rd

Commissioner, 628 F.2d 516 (9th Cir. 1980), for instance, the Court, in applying the origin test to determine if defense and settlement costs were deductible, identified the origin of the suit to be a sale of land, and thus characterized the expenditures in the subsequent fraud suit as nondeductible costs going to the price of land. Id. at 520-21. See also Madden v. Commissioner, 514 F.2d 1149, 1151-52 (9th Cir. 1975), cert. denied, 424 U.S. 912 (1976); DeMink v. United States, 448 F.2d 867, 869 (9th Cir. 1971).

The Court of Appeals for the Ninth Circuit has articulated a two-step process for determining the taxability based on the origin of the claim. Keller Street Development Co., 688 F.2d at 681-82. As the Ninth Circuit noted, first, a careful reading of Gilmore indicates that the "claim" at issue (the origin of which is to be identified) is not the tax claim, but the underlying claim that gave rise to the settlement proceeds (i.e., the event that prompted the cause of action and formed the basis of the suit). The origin is determined by analyzing the facts and determining the nature of the transaction. Id.

The second step requires the Court to characterize the transaction that it identified in the first step. Id. Litigation proceeds are deemed "capital income" if "the origin of the claim litigated is in the process of acquisition itself." Woodward, 397 U.S. at 572 (1970). Because identifying the origin of the claim as a capital transaction does not automatically resolve the tax

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Cir. 1976)(derivative suit not based on concurrent sale of corporation, but rather on management fraud in operation of corporation, cost of suit deductible); Estate of Baier v. Commissioner, 533 F.2d 117 (3rd Cir. 1976)(determination of rights under a patent originated in disposition of capital asset, nondeductible); Brown v. United States, 526 F.2d 135 (6th Cir. 1975)(valuation costs originated in negotiations to sell stock, not deductible); Kimbell v. United States, 490 F.2d 203 (5th Cir.), cert. denied, 419 U.S. 833 (1974)(payment in satisfaction of liability arising from fraudulent sale of capital asset, not deductible); Clark Oil and Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1973)(amount paid to landowner to settle nuisance action not deductible, as origin of dispute was an attempt to acquire the property); Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971)(settlement payment in suit based on breach of contract to sell corporation was a nondeductible capital expenditure); Helgerson v. United States, 426 F.2d 1293 (8th Cir. 1970) (expenses arising from litigation following sale of stock originated in the sale, and are not deductible).

treatment of the payment at issue, a court must next examine how the payment fits into the structure of a capital transaction. Keller Street Development Co., 688 F.2d at 681-82. In characterizing the settlement payment for tax purposes, the test to be applied is stated most simply as "[i]n lieu of what were the damages awarded?" See Dye v. United States, 121 F.3d 1399 (10th Cir. 1997).

In determining the nature of the underlying transaction, the origin of the claim test does not call for a "mechanical search for the first in the chain of events which led to the litigation" but rather requires an examination of all the facts to ascertain the "kind of transaction" out of which the litigation arose. Boagni, 59 T.C. at 713; see Spangler v. Commissioner, 323 F.2d 913, 918 (9th Cir. 1963), affg. T.C. Memo. 1961-341.

In some cases, there may be multiple claims. In such cases, the origin of the claim test requires that the litigation expenses and settlement proceeds be allocated among the various claims actually settled. See Dye, 121 F.3d 1399. Where the settlement agreement does not allocate the settlement proceeds by individual claim the Court must determine how the settlement should be allocated among the various claims actually settled. Id. at 1407.

In Dye, the taxpayer placed her municipal bonds and certain shares in the hands of a stockbroker and incurred large losses. The taxpayer sued the stockbroker alleging securities fraud and mismanagement, common law fraud and breach of contract. The District Court purported to apply the origin of the claim test to determine whether the taxpayer's $200,000 in legal expenses were capital or ordinary, and held that:

> The amended complaint does not reflect litigation involving the process of acquiring or disposing of assets, but rather a lawsuit to compensate an investor for professional misconduct and to punish the alleged wrongdoers through the imposition of RICO treble damages or garden variety punitive damages. The expenses incurred in doing so are not capital in nature and are deductible, if at all, as ordinary business expenditures.

Dye v. United States, 96-1 U.S.T.C. ¶ 50,130 (D. Kan. 1995). In reversing and remanding the case, the Circuit Court noted that:

> In our view, the district court erred in treating the legal expenses as a unified whole, rather than attempting to allocate them based on their respective "origins" in each of [the taxpayer's] legal claims. Where, as here, the litigation involves more than one claim, "[t]he

> origin [of the claim] test must be applied separately to each part." Dolese v. United States, 605 F.2d 1146, 1151 (10th Cir. 1979), cert. denied, 445 U.S. 961 (1980). Legal fees, like other expenses, may, under certain circumstances, be partially deductible and partially nondeductible. See, e.g., Treas. Reg. § 1.212-1(k) ("Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents."); see also Boagni v. Commissioner, 59 T.C. 708, 713-14 (1973) (recognizing that legal expenses can be characterized as both deductible and nondeductible when the litigation is rooted in situations giving rise to both types of expenditures). Consequently, when litigation originates in claims that are both capital and ordinary in nature, the litigation expenses should be allocated between the capital and ordinary income claims. See e.g., Burch v. United States, 698 F.2d 575, 579-80 (2nd Cir. 1983) (taxpayer's legal expenses "should be apportioned between those devoted to establishing [taxpayer's] title to the trust property, which are non-deductible capital expenses, and those devoted to reducing [certain trustee] fees, at least some of which appear to have been deductible expenses for the management of income-producing property. Such an allocation between deductible and non-deductible expenses is not unusual, although a rough approximation is all that can be expected.") (footnote, citations, and interior quote marks omitted); accord, Nickell v. Commissioner, 831 F.2d 1265, 1275-76 (6th Cir. 1987).

Dye, 121 F.3d at 1406. In Dye, since the taxpayer's claims included not only claims for recovery of ordinary income, but also for the recovery of capital assets, the Circuit Court concluded that the origin of the claim test required an allocation of both the settlement proceeds and the litigation expenses to their origins in each of the taxpayer's claims. Since the settlement agreements did not specifically allocate the settlement proceeds, the Court had to address how such an allocation might be made. The Court also had to address how the related legal expenses should be allocated. In conclusion, the Court reversed the District Court and remanded the case for the District Court to allocate both the settlement proceeds received, and the legal expenses paid, between ordinary and capital.

In the instant case, the taxpayer paid $[redacted] to the [redacted] in taxable year [redacted] to settle the counterclaims raised by the [redacted] lawsuits brought in state and federal court. The payment also settled the arbitration action filed by [redacted] involving his employment agreement.

Although the taxpayer started out claiming damages of $[redacted] in an apparent attempt to obtain relief from the provisions of the stock purchase agreement, the taxpayer ended up paying $[redacted] to the [redacted], apparently in response to their counterclaims. The [redacted] claims can be summarized as:

Claims of [redacted] and [redacted]

$[redacted]	due on promissory note
$[redacted]	due on 5-year earnout provision
$[redacted]	due under an inventory agreement
$[redacted]	attorneys' fees and costs
$ unknown	defamation
$ unknown	breach of employment contract

The taxpayer provided a settlement agreement that indicates that it paid [redacted] and [redacted] the following amounts: $[redacted] towards the amount due under the inventory agreement; $[redacted] in attorneys' fees for the litigation and arbitration matters; and $[redacted] for personal injury to the [redacted] personal reputations and mental and physical strain and emotional damages relating to the defamation claims.

Claims of [redacted]

$[redacted]	for breach of purchase contract
$ unknown	attorneys' fees and costs
$ unknown	defamation

The taxpayer provided a settlement agreement that indicates that it paid [redacted] $[redacted], without allocating it, for attorney's fees relating to litigation and arbitration matters, and to compensate for personal injury to the [redacted]'s personal reputation and mental and physical strain and emotional damages relating to the defamation claim.

As part of the settlement, the [redacted] assigned their rights to proceed against [redacted] to the taxpayer. To our knowledge, in the settlement agreement, no amount was allocated for the value of the right to proceed against [redacted].

On the taxpayer's [redacted] return, the taxpayer apparently did not deduct the $[redacted] that it paid pursuant to an inventory agreement. The taxpayer appears to have capitalized $[redacted] that was paid to [redacted] and [redacted] on the promissory note, and appears to have capitalized $[redacted] as a reduction of purchase price (we assume that this means additional purchase price paid by the taxpayer for the [redacted] stock). The taxpayer classified $[redacted] as interest, which it apparently deducted as interest expense. The taxpayer appears to have deducted from ordinary income virtually all of the entire remaining settlement amount, plus $[redacted] of attorneys' fees. We do not know whether the $[redacted] of attorneys' fees constitutes all of the attorneys' fees paid by the taxpayer, or whether there were additional attorneys' fees that may have been capitalized.

We made the following observations after examining the claims raised in the pleadings, the purported allocations in the settlement agreement, and the treatment on the taxpayer's [redacted] return. The original claims of the taxpayer appeared to be an attempt to obtain relief from having to fulfill its outstanding obligations under the stock purchase agreement. The counterclaims by the [redacted] appear to relate to obtaining the taxpayer's performance under the stock purchase agreement, and under the employment contract. The counterclaims of the [redacted] seem to mention defamation as one of their final claims. The settlement agreement classifies a substantial percentage of the payment as personal injury damages based on defamation, despite the fact that the pleadings reflect that they were seeking substantial damages based on the sale of their stock.

Although it appears that the taxpayer has capitalized a portion of the settlement payment, it appears that a large portion was currently deducted, and that, perhaps, some, if not all, of the currently deducted amount should have been capitalized. The payment by the taxpayer of the $[redacted] appears to originate primarily in the acquisition of the [redacted] stock by the taxpayer, and, probably should be capitalized, except to the extent that some other appropriate treatment may relate to the amount paid pursuant to the inventory agreement, or in resolution of a breach of employment contract claim. A portion of the settlement payment may be related to [redacted]'s separate arbitration action concerning the taxpayer's alleged breach of his employment contract. It is possible that, whatever that portion may be, it may have been paid in lieu of wages, and, thus, may be currently deductible. To the extent that a portion of the settlement payment may in fact constitute compensation for personal injury damages, we believe that as the payment arose not in the taxpayer's ordinary course of running its business, but rather appears rooted in the stock acquisition, even an amount for personal injury damages should be capitalized.[9]

We note that the taxpayer has deducted attorneys' fees in excess of $[redacted] The total attorneys' fees related to the arbitration and to the litigation need to be determined. It would appear appropriate that the attorneys' fees should be allocable to currently deductible expense and capital expense in the same proportion as the settlement payment.

You have also requested our opinion concerning the $[redacted] of settlement proceeds received by the taxpayer from [redacted] in [redacted]. According to the settlement agreement, [redacted] paid [redacted] the $[redacted] to compensate [redacted] as set forth in paragraphs F through I and K of the settlement agreement. Those paragraphs state the following:

> F. On or about [redacted], [redacted], [redacted], [redacted] and certain of their officers entered into Settlement Release and Assignment Agreements with [redacted] and [redacted] and [redacted] in compromise and settlement of the various disputes existing between them, including the legal proceedings referred to in paragraph D above. [the Arbitration.]
>
> G. Pursuant to those agreements, [redacted] and [redacted] made certain payments to [redacted] and [redacted] and [redacted] as provided therein.
>
> H. Pursuant to those Agreements, [redacted] and [redacted] and [redacted] assigned to [redacted] any and all claims which they held, or may have held, against [redacted] as set forth therein.
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> I. The [redacted] believe that they would have prevailed in the legal proceedings involving the [redacted]

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[9] We acknowledge that legal expenses and settlement costs incurred in defending against a claim of fraud that would injure or destroy a business have been held to be ordinary and necessary business expenses. Commissioner v. Heininger, 320 U.S. 467 (1943) (legal expenses); North American Investment Co. v. Commissioner, 24 B.T.A. 419 (1931). In this case, such an analysis would seem to be looking to the taxpayer's "primary purpose" in defending the litigation, rather than looking to the origin of the claim. Any fraud on the Taxpayer's part would not seem to have arisen during the ordinary course of its business, but rather as part of its acquisition of the [redacted] stock.

referred to in paragraph D [the Arbitration] above and recovered substantial sums from the [redacted] had it not been for certain conduct of [redacted], its partners and/or its employees (1) during the course of the transaction by which [[redacted]] acquired [redacted] from the [redacted] and (2) in connection with [redacted]'s production of documents during the course of the legal proceedings referred to in paragraph D above [the Arbitration].

K. In order to resolve the dispute that has arisen between them, [redacted] and [redacted], [redacted], [redacted] and [redacted] have agreed to enter into the following Settlement Agreement.

> 1. [redacted] shall pay to [redacted] the total sum of $[redacted].
>
> 2. In consideration of the foregoing, the [redacted] ... and [redacted] ... hereby mutually relieve, release and forever discharge each other... .

The claim that resulted in [redacted] receiving the $[redacted] appears to have its origin in the arbitration. [redacted]s actionable conduct occurred during the arbitration in that it failed to disclose, until the 11th hour, certain internal memoranda reflecting negatively on it and [redacted]. Alternatively, it could be viewed that [redacted]'s negative conduct occurred during the original acquisition process when it apparently failed to disclose to the [redacted] its relationship to [redacted]'s German parent. Again, alternatively, perhaps a court would find that the origin of the claim is partly in the arbitration and partly in the acquisition. We think that the result is the same under any of these views, <u>i.e.</u>, the origin of the claim is the same as the claims which led to the [redacted] settlement payment.

The answer to the question "[i]n lieu of what were the settlement proceeds paid?," is that the settlement proceeds were to compensate [redacted] for the additional consideration it had to pay the [redacted] to settle the arbitration. It is appropriate that the treatment of this "reimbursement" from [redacted] be allocated along the lines of the $[redacted] settlement paid by the Taxpayer to the [redacted]. Accordingly, we think that, whatever the appropriate treatment of the [redacted] settlement expenses, the same treatment should be accorded the [redacted] settlement receipts.

If you have any questions, please call the undersigned at [redacted].

[redacted]
Assistant District Counsel

By: [redacted]
Attorney